April 27, 2004

Members of the Legislative Audit Committee:

We certify that the amount of bonds guaranteed by the Permanent School Fund’s (PSF) Bond Guarantee Program (Program) is within the limit prescribed by Section 45.053(a) of the Texas Education Code. This limit protects the PSF by minimizing the risk of loss to the fund. However, the Program is approaching a second guarantee limit established by an Internal Revenue Service (IRS) letter ruling, a ruling intended to prevent reductions in federal tax receipts due to bond arbitrage (issuing tax-exempt bonds for the purpose of investing the proceeds at higher rates than the tax-exempt bonds).

Based on current trends, the remaining Program capacity of $4.1 billion at August 31, 2003, could be depleted within one year. Therefore, the Texas Education Agency (Agency) will have to prioritize the districts’ bond guarantee requests, rejecting some requests in favor of others, resulting in additional fees or interest costs for the school districts denied guarantees. In addition, if the PSF were to guarantee bonds in excess of the IRS letter ruling limitation, school districts could be assessed penalties.

The Agency is currently developing a method for prioritizing the bond guarantee requests and deciding which ones to honor. Because this prioritization may have school finance policy implications, the Agency should consider presenting its methodology and alternative approaches to the State Board of Education and appropriate legislative committees.

In our April 2002 report (An Audit Report on Certification of the Permanent School Fund’s Bond Guarantee Program, SAO Report No. 02-038), we recommended that the Agency, in conjunction with the Legislature, begin discussions regarding the IRS letter ruling limit and whether it could be reevaluated. We continue to encourage the Agency to work with appropriate parties to determine whether this limit can be raised.

As Figure 1 on the following page shows, the Program’s available capacity has decreased from $8.0 billion at August 31, 2002, to $4.1 billion at August 31, 2003, despite an increase in the state limitation that resulted from the passage of House Bill 1295 (78th Legislature). The IRS letter ruling limitation is more restrictive, and the total amount guaranteed has reached 88 percent of this limit, compared with 77 percent at August 31, 2002.
Without available Program capacity, school districts would have to either purchase a private bond guarantee or pay higher interest rates. Districts with the lowest-level investment grade bond ratings, for example, would have to pay interest rates that, as of April 7, 2004, are from 0.62 to 0.80 percentage points higher than they would pay with a bond guarantee. Having its bonds guaranteed by the Program saves a district private guarantee fees ranging from about 0.22 to 0.40 percent of principal and total interest on average, depending on market conditions and the underlying bond rating of the school district. For example, a 5 percent, 20 year, $20 million bond issue could cost about $78,000 to $142,000 in up-front fees for a private bond guarantee.

In addition, if the Agency guarantees bonds beyond the limitations and the IRS follows Section 148(f) of the Internal Revenue Code, affected school districts will have to pay complicated rebates to keep their bond issues from becoming taxable and to avoid additional penalties of as much as 50 percent of the rebate due plus interest. For example, assuming a 4 percent arbitrage rate, a school district with a $20 million bond issue that exceeds the IRS letter ruling limitation may be required to pay approximately $800,000 in annual rebates. ( Rebates occur when earnings on bond proceeds exceed the bond’s interest rate.)
Although the total amount of bonds guaranteed by the Program is within the limits prescribed by the Texas Education Code and the IRS, we previously identified two related issues that the Agency is addressing to ensure that it continues to comply with these limits, make adequate disclosure, and manage Program risk. Details are provided in the attachment.

The Agency, which approves bonds guaranteed by the PSF, generally agrees with our observations, and its responses are included in the attachment. We also provided the Agency with specific recommendations in a separate management letter regarding school districts’ accounting for accretion on capital appreciation bonds. We appreciate the Agency’s cooperation during this audit. If you have any questions, please contact Carol Smith, CPA, Audit Manager, at (512) 936-9500.

Sincerely,

Lawrence F. Alwin
State Auditor

Attachment

cc: Members of the State Board of Education
    Dr. Shirley Neeley, Commissioner of Education, Texas Education Agency
    Mr. Joe Wisnoski, Assistant Commissioner for School Finance and Fiscal Analysis, Texas Education Agency
    Mr. Holland Timmins, Executive Administrator and Chief Investment Officer, Permanent School Fund
    Mr. Frank J. Zahn, Director of Investment Accounting, Permanent School Fund
Although the total amount of bonds guaranteed by the Permanent School Fund’s (PSF) Bond Guarantee Program (Program) is within the limits prescribed by the Texas Education Code and the Internal Revenue Service (IRS), we previously identified two related issues that the Agency is still addressing to ensure that it continues to comply with these limits. Corrective action for a third issue has been implemented. We provided the Legislative Audit Committee with our previous report (An Audit Report on Certification of the Permanent School Fund’s Bond Guarantee Program, SAO Report No. 02-038, April 2002) and a follow-up report (An Audit Report on Certification of the Permanent School Fund’s Bond Guarantee Program, SAO Report No. 03-032, April 2003) regarding three issues relating to the program limitations. The following table summarizes the issues in those reports and the implementation status of the recommendations.

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Status</th>
<th>Comments</th>
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<tr>
<td><strong>Section 1</strong> - PSF should: Complete its planning and set a target date for systematic accounting for CAB accretion. After PSF quantifies outstanding accretion, it should disclose the amount in the notes to its financial statements.</td>
<td>Partially Implemented</td>
<td>PSF used its investment accounting system to calculate bond accretion, but we found that the results understated total accretion to date and did not agree with accretion amounts reported by school districts. This is because the PSF system excluded initial accretion known as CAB premium and applicable accretion on CAB premium. PSF advised us that significant additional time would be needed to perform side spreadsheet calculations to supplement its automated system to calculate total accretion to date at any point in time. PSF suggested that alternatively it could disclose the difference between the principal amount counted as bonds guaranteed and the ultimate maturity value of the CABs. The alternative disclosure of total accretion to maturity would allow for the monitoring and management of Program risk to provide assurance that the PSF’s guarantee of CABs does not add excessive leverage to the fund. We believe such a disclosure with its report of bonds guaranteed will resolve this issue.</td>
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<td><strong>Section 2</strong> - PSF should discuss an appropriate limit for the Program with bond rating agencies and discuss legislation ... to increase the statutory limit for the Program.</td>
<td>Fully Implemented</td>
<td>The Agency coordinated with the Program bond counsel, rating agencies, and legislative representatives regarding raising the Texas Education Code limits. Representative Hochberg introduced legislation to raise the limit to 2.5 times the cost or market value of the PSF, whichever is lower. This legislation was passed.</td>
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<td><strong>Section 3</strong> - PSF should, in conjunction with the Legislature, informally discuss with appropriate parties the applicability of the arbitrage tax laws to the Program and determine whether the IRS limit can be reevaluated.</td>
<td>Partially Implemented</td>
<td>The Agency coordinated with its previous bond counsel for the Program and requested a reevaluation of the General Land Office deposit reduction factor used in the Program limitation calculation. The IRS advised that the Agency must apply for a new letter ruling to obtain an IRS determination. The Agency has not yet requested a letter ruling from the IRS but expects it will do so about three months after it hires a new bond counsel. The Agency has not addressed the issue with the Texas Office of State-Federal Relations to explore federal legislative relief.</td>
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Chapter 2
Summary of Information Technology Review

Overall, the Agency’s information systems that support the Program appear to be working properly and enabled the PSF to report Program amounts and limitations accurately. However, PSF’s calculation of bond accretion to be used as a future financial statement note disclosure item excludes the premium and applicable accretion of capital appreciation bonds. Tests of reconciliations and financial transactions processed by the information systems indicated that amounts reported were accurate. As part of obtaining an understanding of internal control relevant to our audit, we performed limited general and application control review procedures for the PSF’s major investment information systems.

Chapter 3
Management’s Responses

We at the Texas Education Agency (Agency) recognize the importance of this program to the school districts of Texas and appreciate the efforts made by the State Auditor’s Office to focus not only this agency’s attention but also the attention of the appropriate legislative committees on the issues created as a result of the capacity limitations imposed by the Internal Revenue Service (IRS) regulations.

The Agency is addressing the capacity limitation issue in two ways. First, the Agency has issued a Request for Proposal (RFP) for outside legal counsel to assist the Agency in dealing with the IRS regarding the impact of the current accounting treatment of the proceeds of oil and gas royalties upon the calculation of the IRS limitation. The Agency has reviewed the responses to the RFP and has selected a law firm pending the approval of the Attorney General’s office. Second, the Agency has placed an item upon the agenda for the May 2004 State Board of Education (SBOE) meeting to discuss how the SBOE would want to address the issue of rationing the available bond guarantee capacity. After the SBOE has discussed this issue, Agency staff will develop the appropriate procedures to ensure that the capacity limitation will not be exceeded.

Regarding the status of previously unresolved recommendations from the April 2002 SAO Report No. 02-038, the Agency agrees that for the purposes of improving disclosure to bond holders it will begin to disclose the difference between the principal amount included in the total of bonds guaranteed and the final maturity value of the bond. The Agency agrees that this additional disclosure will finally resolve this issue. With regard to the status of your recommendation in Section 3, the Agency has selected outside legal counsel pending the approval of the Attorney General’s office. Work on requesting the private letter ruling to clarify the accounting treatment of the proceeds from oil and gas royalties will begin as soon as the contract with the outside legal counsel is finalized.
Chapter 4

Summary of Objective, Scope, and Methodology

Our objective was to determine whether the total amount of school district bonds guaranteed by the Program exceeded the limits established by state statute and the IRS and to follow up on related issues from the previous year. We limited the scope to the amount of outstanding guaranteed bonds as of August 31, 2003.

To analyze bond information, we:

- Gained an understanding of governing statutes and business processes.
- Interviewed Program personnel.
- Compared bond information with external sources including the Municipal Advisory Council and independent audit reports of certain school districts.

The certification is required by Section 45.053(b) of the Texas Education Code. This audit was conducted in accordance with generally accepted government auditing standards.